Implications Of Tying State Individual Income Tax Liability To Federal Taxable Income Or Federal Tax Liability

Currently, Montana ties its state individual income tax to federal adjusted gross income (FAGI). Two-earner married couples are allowed to file separate tax returns to take advantage of marginal tax rates ranging from 2% to 11%, and taxpayers may deduct their federal income taxes in full. (Beginning in tax year 2005, SB407 (2003) reduces the top marginal tax rate to 6.9% and caps the deduction for federal taxes at $5,000 ($10,000 for married couples filing jointly).

This document discusses some of the implications of tying Montana's individual income tax to either federal taxable income (FTI) or federal tax liability (FTL). There have been numerous proposals before the state legislature to do this in the past, with Senate Bill 5 (Ellis, 2000 Special Session) among the more notable recent examples.

These proposals generally share some common traits. For example, all have required taxpayers to file for state tax purposes using the same filing status as that used for federal tax purposes. Consequently, two-earner married couples who file separate returns under current law generally are required to file joint returns under these proposals, as over 98% of married couples file jointly at the federal level. Proposals tying to FTI generally provide for separate tax rate tables for single filers, heads of households, and married couples, as is done at the federal level. Proposals tying to FTL generally rely on a single tax rate for all filer types.

Past proposals have been analyzed both in the context of overall revenue neutrality, and in the context of an overall tax reduction. Implications may vary significantly depending on the context of the proposal.

The following sections discuss some of the implications of tying to either FTI or FTL.

SIMPLIFICATION

The primary argument for tying to either FTI or FTL has been that it would greatly simplify Montana's income tax. This was the driving argument behind the Montana Society of Certified Public Accounts (MSCPA) most recent examination of proposals to tie to either FTI or FTL, which ultimately culminated in an endorsement by this group of Senate Bill 5 (2000).

Tying to FTI or FTL would provide for simplification in both tax preparation and tax administration. For many taxpayers, the income tax form would be greatly simplified; there would be no need for most of the current and complicated allocation of income rules required for two-earner couples under the current system. In addition, a large number of households would no longer have to itemize deductions for income tax purposes, as the federal standard deductions exceed itemized deductions currently taken by thousands of households.

Administration would be simplified because there would be fewer tax returns filed; rules and audit efforts regarding the allocation of income and deductions between spouses would no longer be necessary; and there would be reduced administrative expenses associated with data entry, record keeping, forms, computer systems costs, etc.

POTENTIAL FOR INCREASED COMPLIANCE

Generally, studies have indicated that compliance is increased when taxes are easy to understand and simple to prepare. Because proposals of this nature generally enhance understanding of the system and greatly simplify the tax filing process, it is likely that compliance with the state's tax laws would increase.

WINNERS AND LOSERS

Tax reform proposals that are as broad as these invariably result in a significant number of taxpayers and households that gain under the proposals, as well as a significant number that lose under the proposal, particularly in the context of revenue neutrality, but even where there is a modest reduction in total tax liability.

During the summer and fall of 2000, the MSCPA examined the impacts of several different alternative individual income tax reform proposals. Among them were proposals to tie to FTI using separate tax rate tables for different filer types; using a single tax rate table for all filer types; and using a single, flat rate. All of the proposals were analyzed in the context of revenue neutrality. The number of losing taxpayers and households ranged from a low of 111,000 for the proposal with multiple tax rate tables, to 159,000 under the flat rate proposal; in fact, under the flat rate proposal there were more losing than winning households.

SB5 (2000 special session), under one option, reduced total liability by $24 million, but still showed 94,000 losing taxpayers and households, even though 37,000 taxpayers and households were removed from the income tax roll. When the total tax reduction was increased to $36 million there were still over 77,000 losing taxpayers and households.

Historically, it has been very difficult for the Montana Legislature to move proposals that result in this large a number of losing households.

LOW INCOME BENEFITS

Tying to either FTI or FTL would automatically incorporate federal standard deduction and personal exemption levels for all taxpayers. This would result in low-income households being able to shelter a much larger portion of their incomes from tax. Over the years, proposals of this nature have been estimated to remove between 33,000 and 40,000 taxpayers and households from the individual income tax, most of them single filers. The reason for this is apparent in the following table, which shows the amount of income tax that could be earned before any tax liability is incurred.

Maximum Income Before Tax Liability Incurred
Tax Year 2003

Household Type	Current Law	Tie to FTI or FTL
Single Filer	$3,285	$7,800
Head of Household (1 Dependent)	$6,545	$13,100
Married Couple (2 Dependents)	$10,105	$21,700

AUTONOMY IN STATE TAX POLICY CHOICES

Autonomy in state tax policy is diminished as the tax base for state tax purposes moves from FAGI to FTI to FTL. Under a tie to FAGI, states still have the latitude to set and establish their own standard deduction and personal exemption levels. Under a tie to FTI states automatically incorporate the federal standard deduction and personal exemption levels, but may still design and establish their own tax rate tables to meet state policy goals. Under a tie to FTL states essentially abdicate state tax policy to the federal government, except for the overall level of taxation generally established through a single tax rate applied to FTL.

STABILITY OF REVENUE – FEDERAL TAX CHANGES

Regardless of whether states tie their income tax to FAGI, FTI, or FTL, state tax revenues are likely to be impacted by changes in federal tax laws, particularly changes of the type that were part of the federal Tax Reform Act of 1986; the tax reform changes during the Clinton Administration; the Taxpayer Relief Act of 1997; the Economic Growth Tax Relief Reconciliation Act of 2001; the Jobs and Growth Tax Relief Reconciliation Act of 2003 and tax proposals currently contemplated by the Bush Administration.

Federal tax changes can impact state income tax revenues significantly. But federal tax actions have less of an influence if states tie to FAGI, more of an influence if states tie to FTI, and great influence if states tie directly to FTL. In 1999 two states – Vermont and Rhode Island – tied their state tax liability directly to federal tax liability; North Dakota offered an option to tie directly to federal tax liability. Today Vermont and North Dakota tie to federal taxable income, while Rhode Island now ties to FAGI. The significant impact that changes in federal tax laws had on these states' revenue flows has been cited as one significant reason why these states moved away from FTL as their starting point for state tax liability.

INDEXING

For many years now Montana has adhered to the principal that tax liabilities should not increase simply due to inflation. By tying to either FTI or FTL this philosophy is continued, as the federal government fully indexes the federal income tax for inflation.

CURRENT STATE STARTING POINTS

The attachment shows current state starting point for state individual income taxes. Currently, 9 states either have no income tax or tax interest and dividend income only. Six states tie to federal taxable income. Three states tie to federal adjusted gross income and use a single, flat rate. Two states have their own starting point for individual income taxes and use a single, flat rate. The remaining 30 states generally tie to FAGI (four have their own starting point) and have graduated tax rates.